Internal Revenue Service

**memorandum**

CC:TL-N-6948-89
Brl:LJFernandez

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to: District Counsel, Chicago CC:CHI
Attn: Lauren W. Gore
Vijay S. Rajan
Food Industry Counsel -

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Designation of Case as Litigation Vehicle - "Frontloading" of Interest under I.R.C. § 483 prior to Amendments by Tax Reform Act of 1984.

This is in response to your memorandum dated May 16, 1989, requesting that [redacted], a case currently in the Examination Division in the St. Paul District, be designated for litigation in the Food Industry Specialization Program. This designation request has been coordinated with and concurred in by the Food Industry Specialist.

ISSUE

Whether the method used by [redacted], an accrual method taxpayer, to account for payments of unstated interest pursuant to I.R.C. § 483, prior to the 1984 amendments, clearly reflects income under the facts described below.

CONCLUSION

Designation of [redacted] as a litigation vehicle at this time would be premature. We believe that Williams v. Commissioner, T.C. Dkt. No. 36698-87, provides an appropriate vehicle for resolving the issue. The points of distinction between Williams and [redacted] do not result in any substantive difference with regard to whether the Commissioner may require a change in a method of accounting for interest expense pursuant to his power under section 446(b). Further, should Williams be decided in favor of the government on a section 461(g) basis, such reasoning would be equally applicable to an accrual method taxpayer. By our conclusion we do not imply that designation of cases involving industry issues is to proceed "one at a time". The instant issue, however, is unique and we believe it would be prudent to await the outcome of Williams before proceeding with further designations.

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## FACTS

Our telephone conversations with the case manager and a revenue agent involved in the [redacted] audit for its fiscal year ending [redacted], and a submission by the case manager in response to our July 1988 survey indicate the relevant facts to be as follows.

[redacted] wished to retire certain corporate notes (Old Notes) with a face value of $[redacted] in order to eliminate any restrictions on incurring additional debt. In order to achieve this objective, and obtain an accelerated interest deduction in the bargain, [redacted] on [redacted], entered into an agreement with [redacted] to exchange debt instruments. Pursuant to the agreement, [redacted] purchased the Old Notes from certain institutional investors and exchanged said notes for a newly issued [redacted] note (New Note) containing no stated interest rate.

The New Note had a face value of $[redacted] which, when discounted to present value, equalled the exchange value of the Old Notes plus a fee for [redacted], i.e., $[redacted] which included a $[redacted] exchange value and a fee of $[redacted]. The New Note required payment in two equal installments, of $[redacted]; the first due approximately [redacted] months and a few days after the date of exchange and the second due approximately [redacted] years from the date of exchange.

Applying the allocation formula arguably authorized by section 483(a) and described more fully in the underlying regulations, [redacted] reported a deduction for interest expense in the year of the first installment of $[redacted]. Thus, [redacted] had incurred this ostensibly deductible interest expense in exchange for out of pocket fees of $[redacted] before taxes.

## DISCUSSION

The position of the Office of Chief Counsel regarding transactions of the type described above is, as you are aware, fully set forth in Litigation Guideline Memorandum TL-61. You have requested that [redacted] be designated as a litigation vehicle and the analysis set forth in TL-61 be applied to the [redacted] facts. You are aware of the test case of Williams v. Commissioner, T.C. Dkt. No. 36698-87, but you contend that a disposition of Williams may not resolve all of the problems set forth in cases such as [redacted]. You express some concern that the following features in Williams may be found as points of distinction that make a substantive difference from cases such as [redacted]: (1) Purchase of a condominium is the underlying transaction and (2) the taxpayer is an individual

utilizing the cash method of accounting.

We believe that Williams provides an excellent vehicle for resolution of the instant issue and that it would be premature, at this time, to designate another case involving the identical issue. The points of distinction you raise should not result in any substantive difference from cases such as [redacted] from the court's point of view. Although factual distinctions exist, the underlying scheme is basically identical. In both cases, the section 483 allocation formula is being subverted in order to wildly accelerate interest. Like [redacted], Williams employs a one note--two payment scheme. The total purchase price and the amount of the payments differs in the two cases, but the timing of the payments and the material distortion of interest expense that results are substantially similar.

If Williams is decided in the government's favor on the ground that the Commissioner may require a change in a method of accounting for interest expense in order to clearly reflect the taxpayer's income pursuant to section 446(b), then such principle will be equally applicable to [redacted] and other accrual method taxpayers utilizing the identical scheme. If Williams is decided in the government's favor on the ground that the subversion of the section 483 allocation rules results in an acceleration of interest expense in violation of the provisions of section 461(g), then such conclusion would also resolve the issue with regard to accrual method taxpayers notwithstanding the fact that section 461(g) applies only to cash method taxpayers. This is so because 461(g) operates to put cash method taxpayers on the accrual method with regard to prepaid interest. S.Rep. No. 938, 94th Cong., 2d Sess. 104 (1976), reprinted at, 1976-3 (Vol. 3) C.B. 49, 142. Accordingly, the fact that Williams considers a cash method taxpayer will not prevent the application of a well reasoned opinion to cases involving accrual method taxpayers. In this regard, we also note that a case involving an accrual method partnership utilizing the scheme described above is docketed in the Tax Court. Jorman Oak Brook, Ltd. v. Commissioner, T.C. Dkt. No. 32665-88. Consequently, designation simply to address an accrual method taxpayer is not necessary.

For the reasons set forth above, we believe that the factual distinctions between Williams and [redacted] are not sufficient to warrant designation. We also believe a practical consideration militates against designation of [redacted] The regulations underlying section 483 do not vary from the ordinary rules found in section 461 as to the timing of unstated interest deductions for cash method taxpayers. However, such regulations provide a significant adjustment in the timing of unstated interest deductions for accrual method taxpayers. Compare the "All Events" Test of Treas. Reg. § 1.461-1(a)(2) with the provisions of Treas. Reg. § 1.483-2(a)(1) which permits a deduction for

unstated interest by an accrual method taxpayer only when payment is due. Thus, an accrual method taxpayer may present a much more difficult case, from the government's perspective, than a cash method taxpayer because it is easier for an accrual method taxpayer to illustrate that section 483 contains specific accounting rules for the treatment of unstated interest that cannot be overridden by the more general provisions of sections 446(b) and 461(g). Therefore, it would be prudent to await the outcome of Williams before designating the case of an accrual method taxpayer. As discussed above, a favorable opinion in Williams may be used to undercut the position of an accrual method taxpayer and lessen the government's litigating hazards.

Accordingly, we recommend that [redacted] not be designated at this time. By our conclusion we do not intend to imply that designation of cases involving industry issues of widespread importance should proceed "one at a time." Rather, in most instances it is wise to have several litigating vehicles designated in order to establish favorable precedent in the various circuits. The instant issue, however, is unique. We believe it to be highly improbable that the government could prevail in a case involving an accrual method taxpayer should the government lose Williams. It is, therefore, the better course to await the outcome of Williams before proceeding with further designations.

If you have any questions, please contact Lewis J. Fernandez at (FTS) 566-4189.

Signed: Marlene Gross

MARLENE GROSS

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